Rising rate protection is still a potential diversifier

M&G Investments

M&G (Lux) Global Floating Rate High Yield Fund

M&G Wholesale Public Fixed Income team

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- Floating rate notes (FRNs) can potentially benefit from further increases in central bank interest rates due to their variable coupons, or regular interest rate payments, while protecting investors' capital, in our view.
- Credit spreads – the difference between government and corporate bond yields, measuring investors' appetite for risk – appear to be pricing in a hard landing despite consensus expectations of mild recessions in major economies; we believe this creates potential for higher prospective returns.
- Active management can help to mitigate portfolio risks in a recessionary environment, by reducing or avoiding exposure to cyclical sectors and distressed issuers.

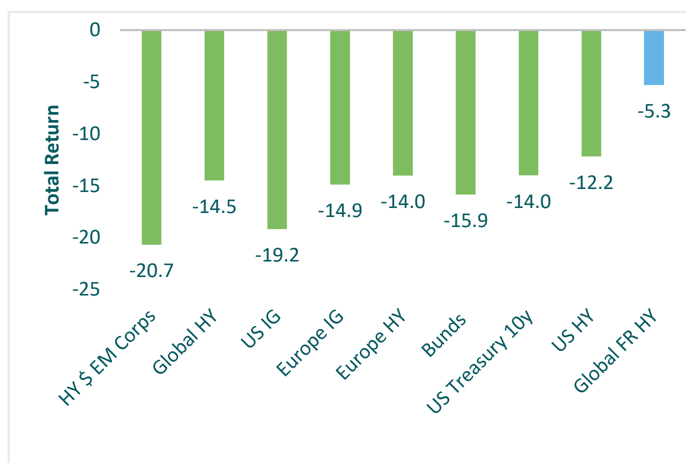
The value of investments will fluctuate, which will cause prices to fall as well as rise. There is no guarantee the fund will achieve its objective, and you may not get back the original amount you invested. Where performance is mentioned, past performance is not a guide to future performance.

A resilient year for HY FRNs

So far, 2022 has been a brutal year for many fixed income investors, with double-digit losses commonplace across government and corporate bond markets. However, high yield (HY) FRNs have proven remarkably resilient, thanks to their effective absence of duration risks (they are not exposed to risks when interest rates change, as their regular interest rate payments to investors vary with market rates); higher yields; lower spread beta (a measure of the volatility of credit spreads) compared to the broader HY universe; and ongoing demand from buyers of HY FRNs see Figure 1.

During this period, our decision to position our portfolio more defensively than the index (for example, by taking positions in companies with less exposure to volatile commodity prices) appears justified, as certain issuers and sectors are more exposed to inflationary pressures and supply shocks than others. However, relative returns have been offset by our synthetic floating rate HY positions, which are designed to increase portfolio liquidity. Synthetic positions seek to use derivatives – instruments whose value is derived from that of an underlying security – to replicate the performance of the underlying securities.

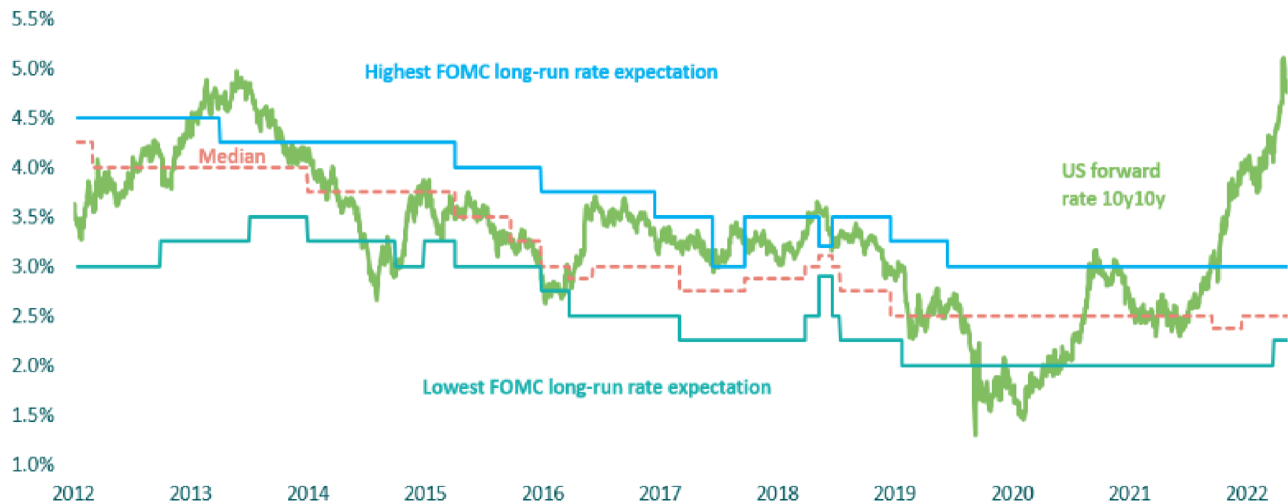
Fig. 1. HY FRNs significantly outperform fixed rate bonds



Past performance is not a guide to future performance.

Source: ICE Bank of America Indices, 31 October 2022. USD hedged returns. Global HY: ICE BoA Global High Yield Index. Global HY FRN: ICE BofA Global High Yield Floating Rate Loan (3% Constrained) Index. US HY: ICE BoA US High Yield Index. Europe HY: ICE BoA European High Yield Index.

Fig. 2. Forward-looking yields versus the Fed's long-term expectations



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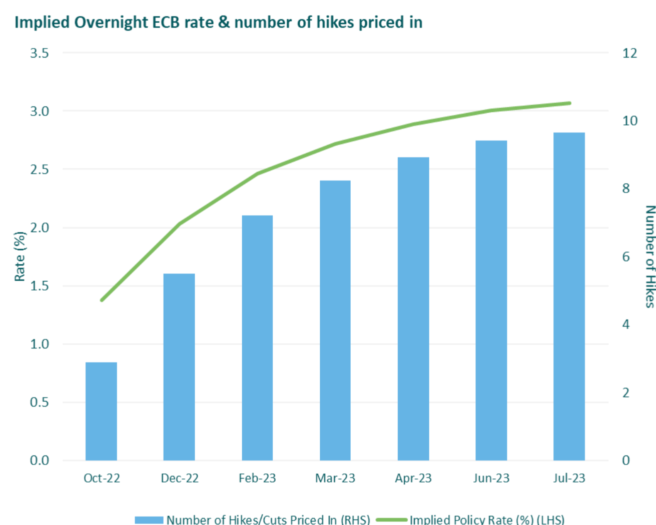
Source: Bloomberg, Federal Reserve, 4 November 2022

Aren't rate hikes already priced in to HY FRNs?

The short answer is 'no'. FRN coupons typically reset every three months in line with cash reference rates, which means the prices of these bonds do not reflect rate expectations beyond this period, since the price of a bond is calculated as the sum of its coupons and principal repayment discounted by the discount rate. Fixed rate bond prices, meanwhile, are sensitive to changes in expected discount rates across the full term of their cash flows. A central bank rate hike expected in six months' time, for example, will not be reflected in today's HY FRN price.

This means there is potential further upside for HY FRN coupons if central banks keep raising interest rates, as markets currently expect they will, while investors' capital is protected by the effective absence of duration risk (see Figures 2 and 3). This contrasts with the dilemma that fixed rate bond investors face, whereby yields have started to look more attractive in nominal terms, but still present risks to capital if central banks need to hike rates more than currently anticipated to combat inflation.

Figure 3. Implied ECB rate & number of hikes priced in



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Source: M&G, Bloomberg, 30 Sep 2022 (latest available).

Mild recession likely, but markets pricing in above-average defaults

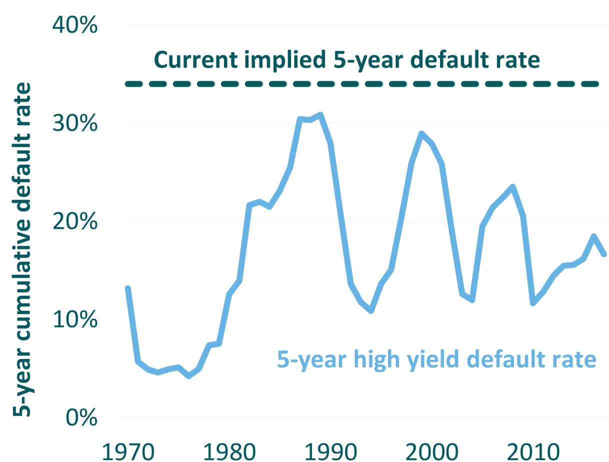
High yield issuers are naturally more exposed to default risks than their investment grade counterparts; however, we believe markets may have moved too far, pricing in above-average default rates, despite consensus expectations by analysts of mild recessions in major economies (see Figure 4).

Many issuers began 2022 with relatively strong balance sheets, having significantly reduced net leverage and increased interest coverage following their post-COVID lockdown recoveries. In our view, this has left these companies in a better position to weather an economic downturn than in many previous recessions.

In the first half of the year, credit spreads on HY FRNs widened from slightly over 400 basis points (bps) to more than 800bps. We believe this more than compensates for the associated default risks in many cases, while active

management enables us to avoid or reduce exposure to riskier companies, such as distressed issuers and those in cyclical industries. Any pivot towards a looser monetary policy could also act as a catalyst for spread narrowing, in our view.

Figure 4. Five-year cumulative default rates



Past performance is not a guide to future performance.

Source: Deutsche bank, ICE Bank of America, Moody's Research, 14 June 2022 (latest data available). Calculated using the CDX HY index with 30% recovery rate assumption.

Bottom-up credit selection seeks to mitigate risks

HY FRNs represent a global asset class and many issuers have an international presence. We remain cognisant of macroeconomic and sectoral trends, and this is reflected in our portfolio positioning. For instance, we have taken positions in companies with less exposure to volatile commodity prices, such as those in the education, finance, and technology, media and telecoms (TMT) sectors, while reducing exposure to retailers.

At the same time, we believe the most significant driver of performance for any individual holding will be the issuer's fundamentals (such as cashflow and earnings), as well as any structural protection provided by the bond. Bottom-up credit research therefore remains the core focus of our approach to constructing a HY FRN portfolio that we believe can perform through the credit cycle, including a potential economic downturn.

Notably, we prefer to invest in senior-secured debt (debt that is backed by an asset as collateral) from asset-heavy companies, as this typically provides more downside protection and better recovery potential in any default scenarios. We have also sought to avoid distressed index constituents, such as in the auto part manufacturing and travel sectors, to reduce potential downside risk.

Activity in the secondary market (where already-issued bonds are traded) has remained healthy throughout 2022; however, we also seek to increase portfolio liquidity and diversification by creating synthetic HY FRN exposure through a combination of selling credit default swaps, which provide access to the broader high yield market, and buying US Treasury FRNs for rate protection and floating rate coupon exposure.

FRN trade is still in play

We believe the FRN trade is still in play, with future rate hikes yet to accrue into these instruments and potentially attractive coupon upside still to come.

Figure 5. Potential HY FRN return scenarios for changing credit spreads and interest rates, USD hedged (base-case highlighted in blue)

Change in interest rates (ppt)	Change in credit spreads (ppt)								
	-2.0	-1.5	-1.0	-0.5	0.0	0.5	1.0	1.5	2.0
-1.0	13.6	12.2	10.7	9.3	7.9	6.4	5.0	3.6	2.1
-0.5	13.7	12.3	10.8	9.4	8.0	6.5	5.1	3.7	2.2
0.0	13.8	12.4	10.9	9.5	8.1	6.6	5.2	3.8	2.3
0.5	14.3	12.9	11.4	10.0	8.6	7.1	5.7	4.3	2.8
1.0	14.8	13.4	11.9	10.5	9.1	7.6	6.2	4.8	3.3

Source: ICE Bank of America Global High Yield Floating Rate Loan (3% Constrained) Index, 23 Nov 2022. Assumption of a 3% default rate with an average recovery of 60% for the floating high yield market. A parallel shift in the yield curve is assumed. The interest rate is SOFR.

This is for illustrative purposes only and based on representative assumptions. This is not a projection or guarantee of future results. It is not possible to invest in an index.

Similarly, although there are near-term headwinds from the economy and tighter lending conditions, high yield credit spreads appear to reflect a hard landing scenario, which in our view appears too pessimistic given the current economic backdrop.

Given the higher real levels of income provided by HY FRNs, alongside their duration protection against potentially stronger central bank policies, as well as their senior secured status, we believe the asset class can continue to be an effective diversifier and a source of stability in fixed income portfolios, potentially offering downside protection against volatility to come.

Looking ahead, we believe it will therefore be important to maintain portfolio liquidity to seek to capitalise on such opportunities, while avoiding those issuers we think will be most at risk to exacerbated near-term pressures. In a mild recession scenario, we believe this could set up the asset class for potentially attractive returns in the subsequent period.

M&G (Lux) Global Floating Rate High Yield Fund

Fund description

The fund aims to provide a combination of capital growth and income to deliver a return that is higher than that of the global floating rate high yield bond market (as measured by the BofA Merrill Lynch Global Floating Rate High Yield Index (3% constrained) USD Hedged) over any five-year period. At least 70% of the fund is invested in high yield floating rate notes (FRNs), focusing on FRNs issued by companies with a low credit rating, which typically pay higher levels of interest to compensate investors for the greater risk of default. Part of the fund may be invested in other fixed income assets, such as government bonds. Asset exposure is gained through physical holdings and the use of derivatives.

Fund performance

Return (%)	YTD to latest quarter	YTD	1 Yr pa	3 Yrs pa	5 Yrs pa	10 Yrs PA
Fund A-H EUR Acc	-7.4	-3.8	-3.2	0.1	0.1	N/A
Benchmark*	-6.1	-2.5	-1.7	2.1	2.2	N/A

Return (%)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Fund A-H EUR Acc	N/A	N/A	N/A	-0.4	6.5	1.6	-2.6	4.3	-0.8	4.5
Benchmark*	N/A	N/A	2.1	-0.7	11.1	2.7	-1.3	6.8	2.0	6.6

Past performance is not a guide to future performance.

*Benchmark = : BofA Merrill Lynch Global Floating Rate High Yield Index (3% constrained) USD Hedged Index. Benchmark prior to 01 April 2016 is the ICE BofAML Global Floating Rate High Yield (EUR Hedged) Index. Thereafter it is the ICE BofAML Global Floating Rate High Yield 3% Constrained (EUR Hedged) Index.

The benchmark is a comparator against which the fund's performance can be measured. The index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction.

The fund is actively managed. The investment manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents.

Fund performance prior to 21 September 2018 is that of the EUR Class A-H Accumulation of the M&G Global Floating Rate High Yield Fund (a UK-authorised OEIC), which merged into this fund on 7 December 2018. Tax rates and charges may differ.

Source: Morningstar, Inc and M&G, as at 30 November 2022. Returns are calculated on a price-to-price basis with income reinvested. Benchmark returns stated in EUR terms.

Key fund risks

- Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund.
- High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

- The fund may use derivatives to profit from an expected rise or fall in the value of an asset. Should the asset's value vary in an unexpected way, the fund will incur a loss. The fund's use of derivatives may be extensive and exceed the value of its assets (leverage). This has the effect of magnifying the size of losses and gains, resulting in greater fluctuations in the value of the fund.
- Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.
- The fund is exposed to different currencies. Derivatives are used to minimise, but may not always eliminate, the impact of movements in currency exchange rates.
- The hedging process seeks to minimise, but cannot eliminate, the effect of movements in exchange rates on the performance of the hedged share class. Hedging also limits the ability to gain from favourable movements in exchange rates.

Further details of the risks that apply to the fund can be found in the fund's Prospectus.

Other important information

The fund allows for the extensive use of derivatives.

Investing in this fund means acquiring units or shares in a fund, and not in a given underlying asset such as a building or shares of a company, as these are only the underlying assets owned by the fund.

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